CHAPTER 1

COSTING

1. Costing

What is costing?

You might be thinking the answer to that question is obvious, surely it's just the process of finding out how much something costs to make?

Or… Is it the cost to the customer? …Should the cost be calculated at the time a product is made or at the time the product is sold? …Are all of the costs incurred by a business supposed to be accounted for in the cost of a single product, or just the materials used to make it? …What about services, how are the costs for those calculated?

Perhaps it's not as simple as you first thought!

Costing isn't just the case of calculating the cost of a product, but is in fact **any system for assigning costs to any element of a business,** for example, **customer groups**, **departments, processes, products, services, facilities or geographical locations.**

A company will therefore use a **costing system, which is a set of processes, controls and reports that are designed to record**, **classify and allocate costs** to different elements of the business. This information on revenues, costs and profitability will then be **used by management for decision-making purposes**.

What is the purpose of costing?

Let’s explain this with an example: Soleful is a fictional company based in Asia that specialises in manufacturing the latest sports shoes, with its own chain of retail shops. There are a number of different reasons the company will use costing systems, here are a few examples:

- **To record costs** - The costs incurred in the making of each pair of trainers will need to be recorded in the statement of profit or loss
- **To control costs** - To understand whether the costs incurred by a specific department are above or below the expected amount
- **To price products** - By understanding how much each pair of sports shoes costs to make, Soleful can determine a selling price which will provide the company with a profit on each pair sold
- **To value inventory** - The cost per unit can be used to value those sports shoes, currently stored in inventory, in the statement of financial position
- **To aid decision making** - The cost information to make important decisions regarding which products or services should be made

2. Types of accounting

Types? There are types of accounting? Don’t all accountants do the same thing? Well actually, no! But don't panic all will become clear.

Meet Fernando, he’s a director at our fictional company Soleful. His job is to make sure that the business is profitable and run effectively.

In order to ensure that he does an effective job, and is able to reassure the rest of the directors that Soleful is profitable, Fernando has a large pile of reports and analysis that he needs to complete or review. Some reports are needed weekly, some monthly, others are quarterly. And if that’s not enough, he also has to present an annual summary to the CEO and the rest of the board. There’s so much data and so many graphs!

Despite all this, Fernando seems to be remaining calm... How so? Well, fortunately for him, whilst gathering and reviewing all this data would take a considerable amount of time, he has got three trusty colleagues to help him out! All are qualified accountants, but they have very different roles:

Let's learn a little more…

Management, cost and financial accounting

While many real-world accountants cover a number of different areas of responsibility, let's meet the three accountants at Soleful who have very clear roles:

Management accountant, Miguel

The management accountant is **concerned with the use of accounting information within the organisation**. This information is then **used to provide management with the basis on which to make informed business decisions.**

Financial accountant, Francesca

A financial accountant **is focused on the recording of financial transactions** and ultimately, on **summarising this information in the financial statements**. Once published, these statements then enable shareholders and other interested parties to understand the financial performance of the business.

Cost accountant, Claudia

Cost accounting is effectively **a sub-category of management accounting** and Claudia **focusses specifically on the recording**, **classification and interpretation of costs for each product, process or job within a business.** This information can then be used by managers across the organisation to **help with cost control and for decision-making purposes**.

Key differences

There are a number of key differences between the three types of accountant. Let's take a look at some of these and consider what Miguel, Francesca and Claudia would do in each respect:

Area	Management accountant	Financial accountant	Cost accountant
Focus	**Broad, forward-looking focus on** supporting future decisions. **Miguel** predicts the likely profitability of a new range of shoes.	**Historical focus** on **reporting past** transactions and results. **Francesca** uses last year's transactions to calculate last year's profits	**Narrow focus on calculating costs**, cost control and cost reduction. **Claudia** calculates the costs incurred in the production of each pair of shoes.
Basis	Looks at **non-financial and financial** information to develop **predictions and estimations** for the future. **Miguel** analyses past sales of similar ranges and market trends to predict the likely success of the new range.	Primarily focuses on **actual, financial information,** to provide **insight on past performance**. **Francesca** records all the completed transactions, such as material purchases, salaries, asset purchases and sales.	Concerned with both **past and present cost data** to assist in the analysis and control of costs within the business. **Claudia** calculates the selling price of the new range, considering the costs incurred in production.
Demographic	Intended for use by **managers within the organisation** to make decisions in the business. **Miguel** produces reports for directors to help them decide whether to go ahead with the new shoe range.	Intended for use by **shareholders, creditors and public regulators** to review a company's past performance. **Francesca** produces financial statements to hold the directors to account for the business performance.	Intended for use by **internal management throughout** the organisation, as well as by management accountants. **Claudia** prepares budget and costing statements which form the basis of management accounting reports.

Area	Management accountant	Financial accountant	Cost accountant
Availability	Usually **confidential and used by management.** **Miguel** files all the reports for internal use only.	**Publicly reported information.** **Francesca** produces the publicly available financial statements.	Usually **confidential and used by management.** **Claudia** prepares statements and reports for internal use.
Construction	Reports and information assembled **subjectively depending on the needs of the user.** **Miguel** has no specific rules to apply. He will deliver the best information necessary to decide whether to proceed with the new range or not – it's what he and his directors decide is useful.	Reports compiled in set formats, **according to general accounting standards.** **Francesca** has to abide by strict standards and record all information in a set way to ensure the information is clearly understandable by external parties reading the accounts.	Reports and information assembled **subjectively depending on the needs of the user.** **Claudia,** like Miguel, has no specific rules to apply and will deliver information in the most convenient format, so that it can be used in reports and statements across the business.

Typically, a **financial accountant,** or auditor, **is often external** and brought in to **ensure the company is complying with financial and accountancy regulations.**

In contrast, a **management accountant** is generally employed by a company to **assess internal information** and analyse how it can be used to **improve performance in the future**, so management accountants **provide information for managers or directors** in the business in order that they can make key business decisions.

Whereas a **cost accountant** is responsible for **providing a set of data that the management accountant can base their analysis on, by calculating costs for different elements of the business**.

CIMA definition

The Chartered Institute of Management Accounting define Management Accounting as:

"The application of the principles of accounting and financial management to create, protect, preserve and increase value for the stakeholders of for-profit and not-for-profit enterprises in the public and private sectors."

3. Planning, decision making and control

The **three key processes that management are generally involved in are planning, decision making and control.** Before we dive into the details though, let's break down each of those three processes and put them into context. We'll do this by revisiting the example of our sports shoe company, Soleful.

Planning

The planning process concerns **setting the direction and objectives** of the business. Planning **can be short-term (tactical planning)** or it can be **long-term (strategic planning)**. During the planning process **a business will use a mission statement** to help set effective goals and objectives.

Soleful has got a new competitor, 'Topshoe'. The company has utilised new technology making the production of sports shoes more efficient; both in terms of reducing costs and increasing productivity at the same time. Soleful needs to act to stay competitive! But how?

Well there are many different options that the management at Soleful may wish to explore. They could look at ways to improve efficiency and reduce costs, as Topshoe has, by investing in new technology or they could explore ways in which the company could expand its customer base by creating new products or targeting new geographic markets.

The managers of Soleful could set a short-term objective of ensuring that sales remain at the same level in their current market over the following 12 months and adjust prices accordingly – this is would be a tactical plan.

The long-term aim however, is to grow the business by expanding into new markets. Soleful can therefore put in place a plan to open 20 stores across Asia over the next five years - this then is a strategic plan.

Decision making

Once a strategic plan is agreed upon, **the next step is to choose the best path towards the realisation of the plan's objectives**. The only way to choose a path is to start making decisions! Usually, there are several options to decide between, so **a manager will look for any relevant and reliable information to help aid their decision**.

For Soleful, to progress with the strategic plan, the business carries out research into the sports shoe market and competing companies across Asia. Having identified the country in which they should open their first store, they can begin making the practical arrangements.

Specific management accounting techniques which you will cover through your management accounting studies that can be applied at tactical level include:

- **Budgeting** - To help with planning and cost management
- **Variance analysis -** To compare budgets with actuals to help make spending decisions
- **Forecasting trends**- To plan for the future
- **Investment appraisal decisions** – Such as net present value on new projects for a division
- **Product costing** -To help make pricing decisions

Control

Once a decision has been made and the relevant actions taken, a manager will want regular feedback going forward, in order to assess whether the objective is being achieved.

By **comparing the expected results to the actual outcome**, they can effectively **reassess their original plans and make changes to improve performance**.

For example, six months after the opening of the first new Asian Soleful store, the management team reviewed the figures and observed that the shop saw rising sales for the first three months, which were in line with predictions, but then sales plateaued, falling short of the forecasts for the following three months.

This has raised concerns; is it because of new competition, incorrect initial analysis of the market, or external market factors such as a slow down in the economy? The management accountant has been tasked with investigating why, as soon as possible!

4. Levels of management, planning and control

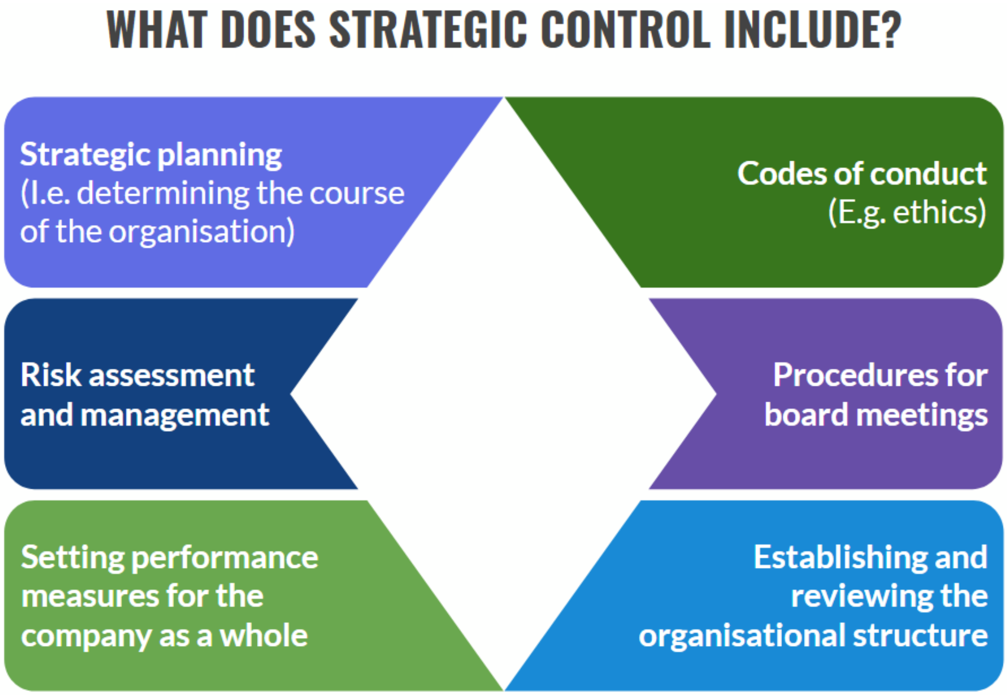
Now we know how the management of a business can set the direction and objectives of the business, but **who exactly is setting the goals and making all of these decisions**?

Would the managing director of Soleful, the international sports shoe company, leave important decisions about the company's strategy to a store manager? Probably not! They have different skills and abilities. Decisions about inventory levels, accepting deliveries and stock management is where their expertise lie and depending on the size of the company, with regards to these decisions, the managing director would potentially know very little.

In organisations, there are **different levels of management** and these levels will **have different levels of control**. Organisations can be divided into three hierarchical levels: **Strategic (senior management), tactical (middle management) and operational (supervisors and their staff)**. These organisational decision-making levels can also be used to distinguish the organisational control levels.

Strategic control

This is the level of control operating **at board level**. It will largely consist of making long-term decisions and **setting the control environment as a whole**. It will include:



Within Soleful, these are the senior managers who are responsible for deciding the new geographic markets the company are going to enter into making decisions relating to mergers or acquisitions and establishing a strategy for the long-term financing of the company by determining, for example, whether the company should become listed on the stock exchange.

Tactical control

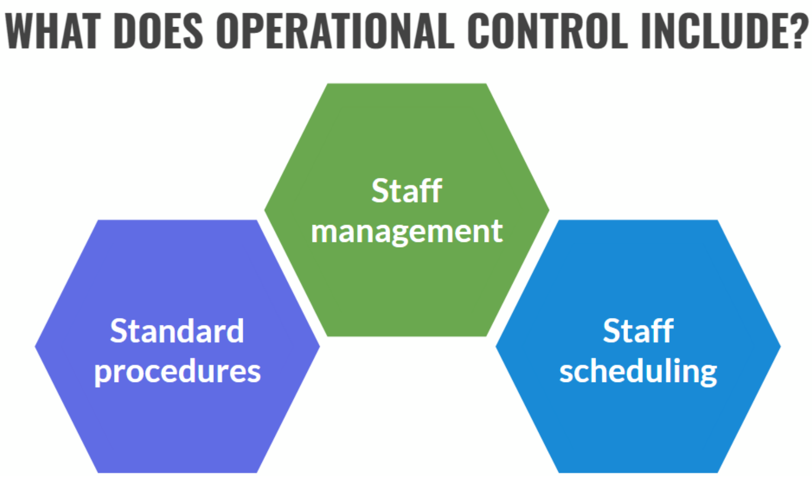
This is **control at the middle management level** of the organisation, and consists of making short-term decisions related to divisional business units. Controls at tactical level include the points illustrated below:

Within Soleful, the area managers in charge of all the shops within a geographical area would be responsible for implementing tactical control. They would need to manage policies from head office, organise and control the store managers and review and manage store budgets.

Operational control

This occurs at the **lower levels of the organisation**. Operational controls are designed to **control structured and repetitive activities** according to **pre-set rules**. For example, a computerised stock control system, where stock levels per component, reorder levels and reorder quantities are calculated and implemented according to predetermined and precise rules.

Controls at operational level include:



Soleful store managers would have responsibility for tasks such as the production of staff rotas, the organisation and control of deliveries and the reordering of stock. They would therefore be implementing the operational control.

Control and the management accountant

Management accountants will **support control activities by helping to provide relevant information. Within** Soleful, they might provide budgets and cost analysis for the area managers to help them understand and control their area's performance, while for the directors they might undertake competitor analysis, product analysis or comparative analysis of the performance of the different geographical areas which the directors would use to assess success of strategic objectives and take action accordingly.

5. Cost transformation and management model

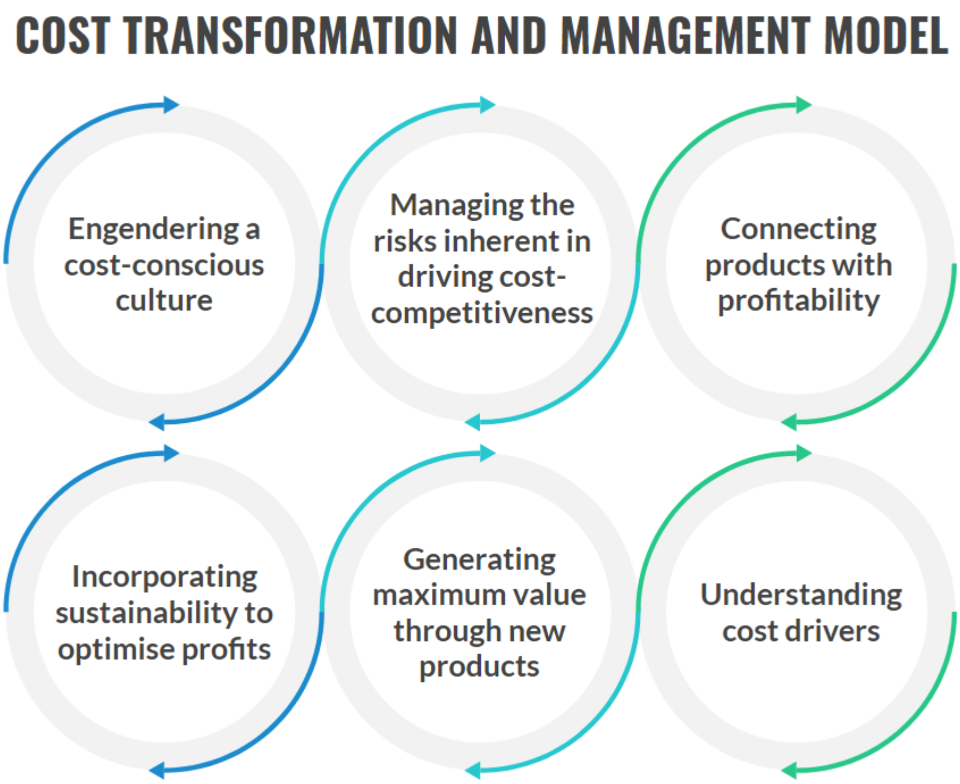
The cost transformation and management model **is practical planning and control tool that has the ultimate aim of helping businesses to achieve and maintain cost-competitiveness**.

The model

The model is made up of **six interrelated areas** that when viewed as a set, will **help organisations achieve and maintain cost-competitiveness in the long-term**.

There are a number of general strategies as well as specific tools that management at a company can use in order to be successful in each of these areas.

(**Note**: Some of the tools mentioned are explained in more detail within this syllabus whilst some are included in other syllabus areas.)



Engendering a cost-conscious culture

To be successful, cost-competitiveness must be a key focus for a business, and at the same time, the value the company provides to its customers must be enhanced and preserved.

For a cost-transformation and management strategy to be successful, all employees need to be aligned to the organisation's purpose and to be able and willing to respond in ways that keep the company agile.

This can be achieved by:

- Making cost transformation and management an integral part of the company strategy
- Supporting, enabling and motivating staff to deliver the company's objectives efficiently and effectively and to continuously improve
- Identifying gaps in the company's capabilities and understanding how these can be overcome
- Understanding that to succeed over the short, medium and long term, change must be viewed as a continuous process

Examples of tools used include: Porters 5 Forces, the balanced scorecard, Kaizen costing and McKinseys 7-S framework.

Managing the risks inherent in driving cost-competitiveness

Understanding the factors that have the potential to prevent a business from achieving its cost transformation and management goals.

This can be achieved by:

- Analysing opportunities and associated risks using tools formally designed to identify these
- Considering whether the business has the resources to withstand each risk
- Determining how willing management are to expose the business to the risk

Examples of tools used include: Enterprise Risk Management (ERM) and risk heat maps.

Connecting products with profitability

Understanding the value a company's products and services generated for its customers.

This can be achieved by:

- Analysing profitability of products and services
- Analysing profitability of different customer groups
- Forming strategies to maximise profitability, by boosting and maintaining sales and, driving and holding costs down

Examples of tools used include: Kotler's five product level model

Incorporating sustainability to optimise profits

A business needs to consider the impact its operations has on the planet's natural resources and must take steps to protect the future availability this natural capital.

This can be achieved by:

- Including sustainability practices in the strategy, outlining the general approach to be taken, the measures that are necessary to ensure these practices are implemented successfully and targets for each of these areas
- Implementing these practices throughout all areas of the business and its supply chain
- Implementing sustainable practices throughout the business can have a number of commercial benefits; boosting the company image and therefore sales, whilst reducing long-term costs and improving profitability

Examples of tools used include: Lifecycle costing and environmental management accounting

Generating maximum value through new products

New products and services should be designed with an element of flexibility, so that features can be added or in fact removed, to suit as many markets as possible, without sacrificing the profit they are able to contribute to the business.

This can be achieved by:

- Ensuring all relevant stakeholders are involved in the early stages of new product design
- Making sure the creative, development and production functions are collaborating
- Taking into consideration the marketable price and the required margin before production begins to avoid costly changes at a later stage
- Targeting products at specific market segments and determining the added value these customers desire, the price they will pay and the likely demand

Examples of tools used include: Target costing and Product Family Master Planning (PFMP)

Understanding cost drivers

Successfully managing costs whilst enhancing customer value is dependent on decision makers having access to the right information.

This relies on a business maintaining comprehensive records and having in place the necessary reporting systems and processes.

This can be achieved by:

- Critical evaluation of systems and processes to ensure they can continue to support effective decision making.
- Planning for the future needs of decision makers, taking into consideration the business model, future plans and strategies

Examples of tools used include: Activity-based costing (ABC), activity-based budgeting (ABB), lean production, beyond budgeting and value chain analysis (VCA)